DORCHESTER
ENERGY INC.

2001 ANNUAL REPORT

Corporate Profile

Dorchester Energy Inc. is a Calgary based junior energy company, active in the exploration, development and production of oil and natural gas in the Western Canadian Sedimentary Basin. Focusing on low risk, multiple zone opportunities in east central Alberta, the Company maximizes return on invested capital through strategic acquisitions, conservative exploration and production optimization while maintaining a strong balance sheet.

The common shares of Dorchester trade on The Canadian Venture Exchange, under the symbol "**DEI**". As at March 31, 2002, the Company had 14,831,328 common shares issued and outstanding.

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Notice of Annual General Meeting

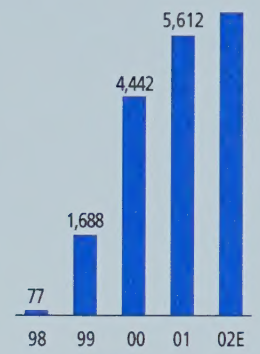
The Annual General Meeting of Shareholders will be held on Wednesday, June 5, 2002 at 10:00 a.m. at the offices of Parlee McLaws LLP, #3400, 150 - 6th Avenue S.W., Calgary, Alberta. All Shareholders are encouraged to attend. Those unable to do so are requested to sign and return the proxy form mailed with this Report.

Abbreviations

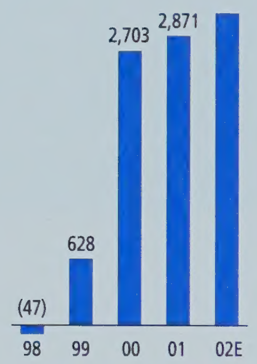
mcf	thousand cubic feet
mcf/d	thousand cubic feet per day
mmcf	million cubic feet
mbbls	thousands of barrels
mstb	thousand stock tank barrels
mmbtu	million British Thermal Units
bbl	barrel
bbl/d	barrels per day
bcf	billion cubic feet
NGLs	natural gas liquids
boe	barrels of oil equivalent (6mcf = 1bbl)
boe/d	barrels of oil equivalent per day
mboe	thousand barrels of oil equivalent
ARTC	Alberta Royalty Tax Credit
WTI	West Texas Intermediate

Corporate Highlights

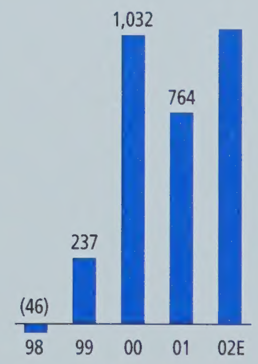
(Canadian Dollars)	**2001**	2000	% Change
Financial			
Gross Production Revenue (net of royalties)	**$ 5,612,142**	$ 4,441,827	26
Funds Provided by Operations	**2,870,877**	2,703,052	6
Per Share	**0.19**	0.20	(3)
Net Earnings	**763,968**	1,032,063	(26)
Per Share	**0.05**	0.08	(35)
Operating Costs per boe	**7.78**	5.65	38
Capital Expenditures (net of dispositions)	**5,252,105**	4,140,727	27
Bank Debt and Working Capital	**4,322,104**	2,000,097	116
Shares Outstanding at Year-end	**14,831,328**	14,656,328	1
Operating			
Average Daily Production			
Crude Oil & NGLs (bbl/d)	**225**	153	48
Natural Gas (mcf/d) @ 6:1	**2,581**	1,876	38
Barrel of Oil Equivalent (boe/d)	**656**	465	41
Average Selling Price			
Crude Oil & NGLs ($/bbl)	**27.09**	34.01	(20)
Natural Gas ($/mcf)	**5.30**	5.02	6
Barrels of Oil Equivalent ($/boe)	**30.17**	31.40	(4)
Reserves			
Proven			
Oil & NGLs (mbbls)	**556.2**	463.0	20
Natural Gas (bcf)	**4.81**	5.64	(15)
Thousand Barrels of Oil Equivalent (mboe)	**1,358.0**	1,403.0	(3)
Proven and Half Probable			
Oil & NGLs (mbbls)	**662.3**	554.0	20
Natural Gas (bcf)	**5.77**	7.40	(22)
Thousand Barrels of Oil Equivalent (mboe)	**1,624.0**	1,787.0	(9)
Undeveloped Land (Acres)			
Gross	**29,610**	31,000	(4)
Net	**14,155**	15,500	(9)



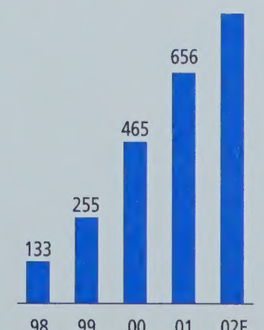
Revenue *($m)*



Funds Provided by Operations *($m)*



Net Earnings *($m)*



Production *(boe/d 6:1)*

Message to Shareholders

This past year proved to be a challenging environment for most oil and gas companies. After experiencing strong commodity prices for the first half of 2001, there was a dramatic decline commencing in the third quarter of the year. Despite the decrease in demand levels resulting in much weaker product prices, Dorchester remained steadfast to conducting its operations prudently and conservatively.

Production levels averaged 656 boe/d consisting of 225 barrels of crude oil and NGLs (34%) and 2.58 mmcf/d of natural gas (66%). Given that some of the production was increased in the last quarter of 2001, we expect 2002 to result in higher average production levels for the year. Current daily production to the end of first quarter, 2002 is approximately 300 barrels of oil and liquids and 3.2 mmcf/d of natural gas or 833 boe/d.

During 2001, the Company increased production by way of acquisitions as well as drilling. In the first quarter of 2001, the Company completed the acquisition of a natural gas property in the Richdale/Michichi area of southern Alberta. Natural gas production was also increased late in the year from Ashmont and Michichi, Alberta. On the oil side, Dorchester operated a successful drilling program in the Bow Island area of southern Alberta. Of the five wells drilled, four wells were successfully brought on production.

Due to declining prices in oil and natural gas in the last quarter of 2001, the Company deemed it prudent to defer its program slated for a number of drilling opportunities. More recently, as natural gas prices appear to have stabilized somewhat, these projects are now planned for the second and third quarters of 2002, in anticipation of stronger gas prices for the latter half of this year.

2001 Performance

- Gross revenue (net of royalties) increased to $5,612,142
- Funds provided by operations increased to $2,870,877
- Net earnings decreased to $763,968
- Year-end exit production increased to 833 boe/d (6:1)
- Established an inventory of low-risk drilling prospects with the objective of increasing production and cash flow in the near-term
- Committed to focusing on the acquisition and development of shallow gas, low risk prospects in south-central Alberta
- The Company's overall product mix is well balanced at 34% oil and 66% natural gas.

Outlook

The anticipated recovery in the United States' economy over the next year, coupled with uncertainty over current events in the market should allow for firm prices over the balance of 2002. Our focus on shallow east central Alberta natural gas properties will be maintained. Additionally, as a result of drilling and production successes achieved at Bow Island, oil development will play an increasingly important role for Dorchester's ongoing development plans. Growth will be generated from existing cash flow combined with moderate amounts of debt and equity later this year. Approximately two-thirds of 2002 expenditure levels will be directed towards drilling with the balance targeted for acquisitions.

In its fourth year of operations under the current management team, Dorchester is aiming to reach increased production and cash flow levels to those of a solid and successful junior oil and gas company, consistently building shareholder value while managing its debt at a conservative level.

In closing, I would like to thank our shareholders for their commitment in seeing Dorchester reach its next level of growth and to the Directors for their guidance as well as all our staff, consultants and contractors for their contributions over the past year.

Murray K. Scalf
President

April 23, 2002

Concentrating on low risk, multiple-zone opportunities in east central Alberta, Dorchester's growth will be based on conservative exploration, strategic acquisitions and production optimization.

EAST CENTRAL ALBERTA (CORE AREA)

Over the past three years, the Company has maintained its focus on east-central Alberta pursuing natural gas drilling and acquisition opportunities. This core area is broken into four main geographical/production blocks: Richdale, Michichi, Willow and Three Hills. Production from this area is currently 2.1 million cubic feet of natural gas per day with 30 barrels of oil and natural gas liquids per day. In 2001, Dorchester purchased existing production at Richdale, and participated in drilling a successful well at Three Hills. The Company will continue to acquire production and undeveloped land in this area with plans to drill or re-enter six wells in 2002.

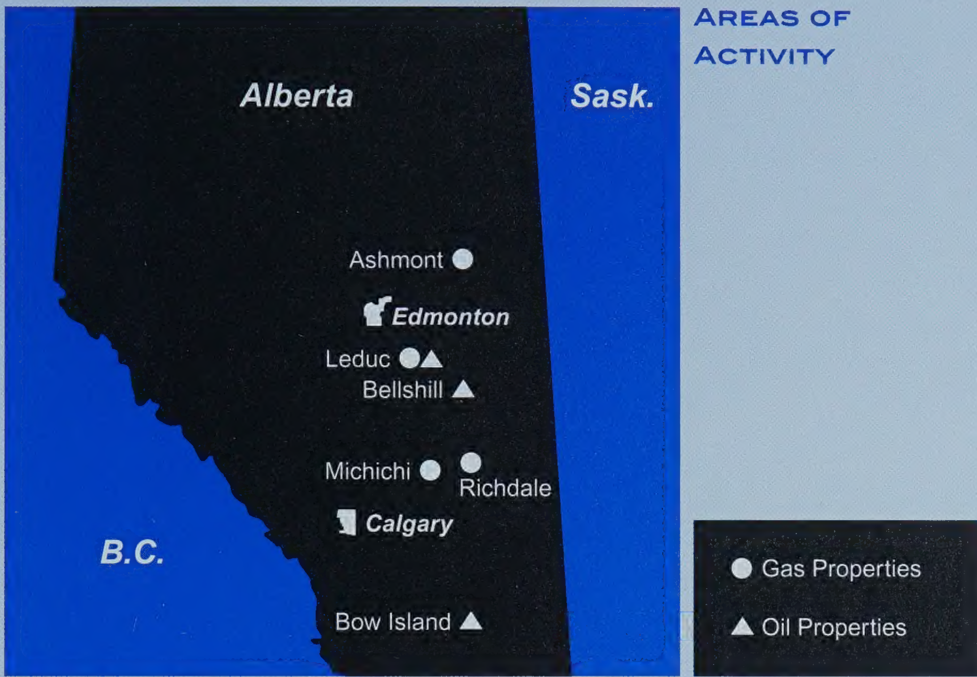
BOW ISLAND

In the first quarter of 2001, Dorchester drilled a successful delineation well into an existing Sawtooth oil pool. Over the course of the year, three additional wells were drilled into the same pool, resulting in substantial oil production increases for the Company. During the third quarter, construction of a gathering system and satellite facility were completed. Production from the property is currently 120 bbl/d net to Dorchester. Plans for 2002 include one further delineation well in the Sawtooth pool and two infill locations.

OTHER AREAS

Ashmont *(DEI 50%)*

Ashmont is a mature gas-producing property with a large land spread and excellent infrastructure. The operator of the property has undertaken steps to enhance production largely through workovers and tie-ins of suspended wells. The Company participated in



Areas of Activity

the drilling of one well, the recompletion of three wells and the tie-in of two previously suspended wells. A similar program is planned for 2002. Dorchester is also reviewing acquisition and development opportunities in the area to complement its existing operations. Production from the area is currently 600 mcf/d net to Dorchester.

Bellshill Lake *(DEI 1.1%)*

Production at the Bellshill Lake Unit oil property remained relatively stable over the past year. The operator plans to drill up to 22 wells in 2002 to maintain Dorchester's 46 boe/d of production.

Leduc *(DEI 3.5%)*

The emphasis on Mannville gas recompletions in the Leduc D-3 Unit has changed to include optimization of oil production. The operator of the property has undertaken a number of workovers and stimulations in the Leduc zone with considerable success. The wells are being placed on high volume lift with significant increases in oil production. Up to 20 wells will be worked over in 2002. Production from this property in 2001 was 180 boe/d.

Reserves

The sales volumes and net present value of the petroleum and natural gas reserves have been evaluated as at January 1, 2002 by Sproule Associates Limited, our independent engineering consultants. The reserves presented in the following table represent Dorchester's share of the sales volumes before royalty burdens.

Reserves Summary

	Remaining Recoverable Reserves			
	Proved	50% Probable	Proved plus 50% Probable	6:1 Mboe
Gas (bcf)	4.811	0.959	5.770	961.7
Oil & NGLs (mstb)	556.2	106.1	662.3	662.3
				1,624.0

On a proven basis, natural gas represents 59% and crude oil and NGLs represent 41% of the Company's year-end reserves at a conversion of 6 mcf = 1 bbl. The associated pricing assumptions, as determined by Sproule Associates Limited, are as follows:

Pricing Assumptions

As at January 1, 2002

Year	Oil WTI @ Cushing ($US/bbl)	Gas AECO ($Cdn/mmbtu)	Exchange Rate ($US/Cdn)
2002	20.15	3.70	0.63
2003	22.36	4.26	0.64
2004	24.20	4.26	0.64
2005	24.57	4.27	0.64
2006	24.93	4.37	0.64

Engineering Evaluation

As at January 1, 2002 the net present worth of the oil and natural gas properties is as follows:

PV 10%	
Proven	$ 13,353,000
Proven & Probable	$ 16,910,000

Management's Discussion and Analysis ("MD&A") should be read in conjunction with the audited years ended December 2001 and 2000 statements. Per barrel of oil equivalent ("boe") amounts have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil.

OPERATING HIGHLIGHTS

Year ended December 31,	**2001**	2000	% Change
Average Daily Production			
Crude Oil & NGLs (bbl/d)	**225**	153	48
Natural Gas (mcf/d)	**2,581**	1,876	38
Barrel of Oil Equivalent (boe/d)	**656**	465	41
Average Selling Price			
Crude Oil & NGLs ($/bbl)	**27.09**	34.01	(20)
Natural Gas ($/mcf)	**5.30**	5.02	6
Barrels of Oil Equivalent ($/boe)	**30.17**	31.40	(4)
Production Expense per boe	**7.78**	5.65	38
G&A Expense per boe	**2.36**	4.25	(44)

Financial Highlights

Year ended December 31,	2001	2000	% Change
($000s except per share data)			
Oil and Natural Gas Revenue	**7,220**	5,423	33
Funds from Operations	**2,871**	2,703	6
Per Share - Basic	**0.19**	0.20	(3)
Per Share - Diluted	**0.19**	0.20	(5)
Net Earnings	**764**	1,032	(26)
Per share - Basic	**0.05**	0.08	(33)
Per share - Diluted	**0.05**	0.08	(34)
Change in Total Net Debt	**4,322**	2,000	116
Capital Expenditures, Net	**5,252**	4,141	27
Shareholder's Equity	**3,798**	2,975	28
Common Shares, Weighted Average			
Basic	**14,741,924**	13,403,753	10
Diluted	**15,354,963**	13,701,658	12
End of Period	**14,831,328**	14,656,328	1
Stock Options	**1,419,333**	1,384,333	3

Reserves

Year ended December 31,	2001	2000	% Change
Proven			
Oil & NGLs (mbbls)	**556.2**	463.0	20
Natural Gas (bcf)	**4.81**	5.64	(15)
Thousand Barrels of Oil Equivalent (mboe)	**1,358.0**	1,403.0	(3)
Proven and Half Probable			
Oil & NGLs (mbbls)	**662.3**	554.0	20
Natural Gas (bcf)	**5.77**	7.40	(22)
Thousand Barrels of Oil Equivalent (mboe)	**1,624.0**	1,787.0	(9)
Undeveloped Land (Acres)			
Gross	**29,610**	31,000	(4)
Net	**14,155**	15,500	(9)

Production Revenue

Gross production revenue for 2001 increased 33% to $7.2 million from $5.4 million in 2000. This substantial increase was primarily due to a 41% increase in production volumes, partially offset by a 4% decrease in the average selling price.

Outlined below is a summary of petroleum and natural gas revenues for Fiscal 2001.

	Daily Production	Annual Production	Average Price	Total Revenues
Oil and NGLs (bbls)	225	82,273	$ 27.09	$ 2,228,437
Natural Gas Sales (mcf)	2,581	942,153	$ 5.30	$ 4,991,592
Total				$ 7,220,029

Average daily production for 2001 of 656 boe/d included a mix of 34% oil and NGLs and 66% natural gas. The substantial increase was attributed to the acquisition of Richdale properties as well as five wells drilled in the Bow Island area.

Operating Netbacks

($/boe)	**2001**	2000	% change
Price	**$ 30.17**	$ 31.40	(4)
Royalties (net of ARTC)	**(6.75)**	(5.78)	17
Royalty Rate	**(22)**	(18)	21
Operating Expenses	**(7.78)**	(5.65)	38
Field Netback	**$ 15.64**	$ 19.97	(22)
Other Income	**0.17**	–	–
General and Administration Expenses	**(2.36)**	(4.25)	(44)
Interest and Finance Charges	**(0.67)**	(0.34)	99
Current Income Taxes	**(0.82)**	–	–
Cash Flow Netback	**$ 11.96**	$ 15.38	(22)
Depletion and Depreciation	**(7.69)**	(5.22)	47
Future Income Taxes	**(1.11)**	(4.61)	(76)
Earnings Netback	**$ 3.16**	$ 5.55	(43)

Royalties

In 2001, royalties (net of ARTC) increased 64% to $1.6 million or 22% of revenue from $0.98 million or 18% of revenue in 2000. The increase was due to higher gross revenues resulting from increased oil and gas production volumes.

Production Expenses

Increased production volumes and higher costs associated with oil production from Bow Island caused operating costs to increase to $1.86 million in 2001 (2000 – $0.96 million). 2001 costs equated to $7.78 per boe, compared to $5.65 per boe in 2000, an increase of 38%. The increase is primarily due to the construction of a gathering system and satellite facility at Bow Island and higher power and fuel costs related to field operations.

Other Revenue

Other revenue in 2001, of $41,481 consisted entirely of processing revenue.

General and Administrative

General and administrative expenses in 2001 decreased to $0.56 million compared to $0.72 million in 2000. Most of the decrease in administrative expenses is attributable to the increase in operating recoveries and the capitalization of costs related to exploration. On a boe basis, administrative expenses were $2.36 compared to $4.25 in 2000, a decrease of 44%.

Interest Expenses and Other Finance Costs

Interest expense increased from $57,271 in Fiscal 2000 compared to $160,817 in Fiscal 2001, a 181% increase. This was due to a substantial increase in the Company's bank loan, which totaled $3.9 million in 2001 compared to $0.2 million in 2000. The loan was used to assist in the financing of a significant acquisition in February 2001 and maintaining active drilling, completion and tie-in programs throughout 2001.

Depletion, Depreciation and Amortization

Depletion, depreciation and amortization provision, exclusive of the provision for site restoration, increased to $1.69 million in 2001 from $0.83 million in 2000. This significant increase is due to increased production volumes and asset base.

Provision for Site Restoration

The site restoration provision for 2001 was $153,464 (2000 – $54,298) and is intended to cover the liability associated with future well abandonment and site restoration costs. As at December 31 2001, the estimated liability for future well abandonment and site restoration costs was $1,101,750 (2000 – $812,500) of which $237,997 (2000 – $84,533) has been recorded in the financial statements.

Future Income Taxes

Current income taxes include federal and provincial taxes payable of $195,424.

Dorchester's future income tax liability was $1,807,000 at December 31, 2001 an increase of $264,824 from 2000. This increase was largely attributable to the Richdale property acquisition. Effective January 1, 2000, Dorchester adopted the liability method of accounting for future income taxes.

At December 31, 2001, Dorchester had an estimated $5.7 million of tax pools to be deducted against future taxable income, compared to $3.4 million at December 31, 2000.

Net Income and Cash Flow

The Company experienced a decrease in earnings and increase in cash flow in 2001 as a result of increased depletion and operating costs offset by increased production and product prices earlier in the year. Net earnings decreased 26% to $0.76 million in Fiscal 2001 from $1.03 million in 2000. This equated to $0.05 per share basic ($0.05 diluted) compared to $0.08 per share basic ($0.08 diluted) in 2000.

Cash flow from operations increased 6% to $2.87 million, $0.19 per basic share ($0.19 diluted), from $2.7 million, $0.20 per basic share ($0.20 diluted) in 2000. On a boe basis, cash flow netback decreased 22% to $11.96 compared to $15.38 for 2000 as a result of decreasing product prices and a change in product mix to the end of 2001.

Capital Expenditures

During 2001, Dorchester's capital expenditures increased 27% to $5.25 million, compared to $4.14 million in 2000. In February, Dorchester completed an acquisition in the Richdale area of Alberta for a purchase price of $0.86 million.

Segmented capital expenditures are outlined below.

($000's)	2001	2000	% change
Land and Lease	**$ 389**	$ 322	21
Drilling and Completions	**2,138**	3,635	(41)
Production Facilities, Pipeline, Plant and Equipment	**1,630**	295	453
Acquisitions	**860**	–	100
Dispositions	**–**	(117)	(100)
Capitalized General and Administrative Expenses	**203**	–	100
Office	**32**	6	533
	$ 5,252	$ 4,141	27

Liquidity and Capital Resources

At December 31, 2001, Dorchester had 14.8 million common shares outstanding, compared to 14.7 million shares outstanding at December 31, 2000.

At December 31, 2001, Dorchester had 1,419,333 stock options for common shares outstanding of which 1,209,333 were exercisable at an average price of $0.28 equating to proceeds of $0.34 million.

At December 31, 2001, the Company had a $6.0 million demand revolving loan facility bearing interest at prime plus 1%, with the amount drawn under this facility of $3.9 million compared to $0.2 million at December 31, 2000. This facility was used to finance the Company's capital spending program and the Richdale property acquisition.

At December 31, 2001, the working capital deficiency was $422,104 compared to a surplus of $917,323 in 2000. The combined debt and working capital deficiency was $4,322,104 (2000 – $2,000,097) which was approximately 1.5 times our 2001 cash flow from operations compared with to a 0.7 ratio at year end 2000.

Business Risks

Dorchester, like all oil and gas exploration companies, is subject to inherent risks associated with exploration, development, reservoir performance, marketing, price fluctuations, interest rates and money market exchange rates. Management attempts to manage this risk by designing capital programs tempered with low, medium and high risk projects, with the understanding that higher risk projects often carry higher reward and longer term value.

Dorchester has competent technical staff and uses up-to-date technology to not only find, but also maximize the return from the Company's producing properties. The Company maintains an insurance program consistent with industry practice to protect against destruction of assets, safety and environmental risks, and other business interruptions.

Dorchester is exposed to a variety of market risks including changes in commodity process, foreign currency exchange rates and interest rates. The Company's financial results can be significantly affected by the prices received for oil and natural gas production as commodity prices fluctuate in response to changing market forces. This volatility is expected to continue. The Company's financial results are exposed to fluctuations in the exchange rate between the Canadian dollar and the US dollar. Crude oil and, to a large extent, natural gas prices are based on reference prices denominated in US dollars, while the majority of expenses are denominated in Canadian dollars. Dorchester may be exposed to changes in interest rates as the Company's credit facilities are based on our lenders' prime lending rate. The Company uses various risk management activities to mitigate the effects of these market risks. Derivative instruments are not used for speculative purposes.

Financial Controls

Dorchester utilizes appropriate accounting systems that are in place. The Company employs well-trained accounting personnel who are experienced with the needs unique to the industry. As a public company trading on the Canadian Venture Stock Exchange and listed with the Securities Commissions in the provinces of Alberta and British Columbia, Dorchester is subject to stringent regulatory approvals and reporting practices. These require complete financial statements (unaudited) at the end of each quarter and audited financial statements annually. Accordingly, an accounting system, with budgetary and reporting procedures, is in place to ensure compliance and to provide accurate and generally accepted financial statements. The Company believes it has sufficient budget and reporting procedures in place to provide maximum accountability.

Safety and Environment

Dorchester is committed to the protection and preservation of the environment and the health and safety of its employees and the public in the conduct of its business. To guide Company personnel in completing daily operating and project responsibilities, Dorchester has adopted a series of environmental principles. The Company will apply the expertise necessary to implement these principles and will require contractors providing services to operate in a manner consistent with corporate policies. These guiding principles reflect current environmental legislation and accepted industry practice, and are incorporated into Dorchester's ongoing activities.

Accounting Standard Change

In 2002, the Company will be required to adopt a new Canadian accounting standard relating to stock based compensation and other stock based payments to non-employees. The new standard is to be applied prospectively for stock based payments to non-employee awards that are direct awards of stock. For such awards in the future, the Company will be required to follow the fair value method, as prescribed in the standard and calculate a fair value of the stock granted and record that fair value as an expense over the term of the grant. All prior grants have been to employees and the Company does not expect the adoption of the new standard to have a material impact on the Company's financial condition or results of operations.

Management's Report to Shareholders

The accompanying financial statements and all information in the Annual Report are the responsibility of management. The financial statements have been prepared by management in accordance with the accounting policies described in the notes to the financial statements. The financial statements have been prepared within acceptable limits of materiality and are in accordance with Canadian generally accepted accounting principles appropriate in the circumstances. The financial information contained elsewhere in the Annual Report has been reviewed to ensure consistency with that in the financial statements.

Management maintains a system of internal accounting controls, policies and procedures in order to provide reasonable assurance as to the reliability of the financial records and the safeguarding of assets.

External auditors, appointed by shareholders of the Company, have examined the financial statements and have expressed an opinion on the statements. Their report is included with the financial statements.

The Board of Directors of the Company has established an Audit Committee, consisting of non-management directors, to review these statements with management and the auditors. The Audit Committee has approved these statements on behalf of the Company's Board of Directors.

Murray K. Scalf
President
April 5, 2002

Dwight D. Fieseler
Controller

Auditors' Report to the Shareholders

We have audited the balance sheets of Dorchester Energy Inc. as at December 31, 2001 and 2000 and the statements of earnings and retained earnings and cash flow for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2001 and 2000 and the results of its operations and its cash flow for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Calgary, Canada
April 5, 2002

As at December 31, 2001 and 2000	2001	2000
Assets		
Current assets:		
Accounts receivable	**$ 1,849,024**	$ 2,750,149
Prepaid expenses	**140,010**	384,831
	1,989,034	3,134,980
Capital assets *(note 3)*	**10,165,253**	6,601,768
	$ 12,154,287	$ 9,736,748
Liabilities and Shareholders' Equity		
Current liabilities:		
Cheques issued in excess of funds on deposit	**$ 41,537**	$ 2,717,420
Accounts payable and accrued liabilities	**2,369,601**	2,217,657
	2,411,138	4,935,077
Long-term debt *(note 4)*	**3,900,000**	200,000
Provision for future site restoration	**237,997**	84,533
Future income taxes *(note 6)*	**1,807,000**	1,542,176
Deferred income taxes	**–**	–
Shareholders' equity:		
Share capital *(note 5)*	**1,631,465**	1,572,243
Contributed surplus	**13,250**	13,250
Retained earnings	**2,153,437**	1,389,469
	3,798,152	2,974,962
	$ 12,154,287	$ 9,736,748

See accompanying notes to financial statements.

On behalf of the Board:

Director

Director

Statements of Earnings and Retained Earnings

Years ended December 31, 2001 and 2000	2001	2000
Revenue:		
Petroleum and natural gas	$ 7,220,029	$ 5,423,468
Royalties (net of Alberta Royalty Tax Credit)	(1,607,887)	(981,641)
	5,612,142	4,441,827
Other	41,481	–
	5,653,623	4,441,827
Expenses:		
Operating	1,861,035	959,025
General and administrative	565,471	722,479
Depletion, depreciation and amortization	1,842,085	887,263
Interest	160,816	57,271
	4,429,407	2,626,038
Earnings before income taxes	1,224,216	1,815,789
Income taxes *(note 6)*:		
Current income taxes	195,424	–
Future income taxes	264,824	783,726
	460,248	783,726
Net earnings	763,968	1,032,063
Retained earnings, beginning of year	1,389,469	357,406
Retained earnings, end of year	$ 2,153,437	$ 1,389,469
Earnings per share:		
Basic and diluted	$ 0.05	$ 0.08

See accompanying notes to financial statements.

Years ended December 31, 2001 and 2000	2001	2000
Cash provided by (used in):		
Operations:		
Net earnings	$ 763,968	$ 1,032,063
Add items not utilizing cash:		
Depletion, depreciation and amortization	1,688,621	832,965
Provision for site restoration	153,464	54,298
Future income taxes	264,824	783,726
Funds provided by operations	2,870,877	2,703,052
Net change in non-cash working capital items related to operating activities	(1,767,272)	1,627,753
	1,103,605	4,330,805
Financing:		
Long-term debt	3,700,000	(850,000)
Issuance of shares (net of issue costs)	58,850	489,100
Share purchase loan	372	(59,297)
Net change in non-cash working capital items related to financing activities	(11,000)	–
	3,748,222	(420,197)
Investing:		
Acquisition of capital assets	(5,252,105)	(4,257,993)
Disposition of capital assets	–	117,266
Net change in non-cash working capital items related to investing activities	400,278	230,119
	(4,851,827)	(3,910,608)
Net increase (decrease) in cash	–	–
Cash and short-term deposits, beginning of year	–	–
Cash, end of year	$ –	$ –
Funds from operations per share:		
Basic and diluted	$ 0.19	$ 0.20

See accompanying notes to financial statements.

Years ended December 31, 2001 and 2000

Dorchester Energy Inc. (the "Corporation") is incorporated under the laws of the province of Alberta. The Company is active in the exploration, development and production of oil and gas, primarily in Alberta.

1. SIGNIFICANT ACCOUNTING POLICIES:

(a) Oil and gas assets:

The Corporation follows the full cost method of accounting for petroleum and natural gas properties whereby all costs relating to the exploration for, and acquisition and development of, petroleum and natural gas reserves are capitalized into a single Canadian cost centre. Such costs include lease acquisitions, geological and geophysical activities, lease rentals on undeveloped properties, drilling of both productive and unproductive wells, plant and equipment costs, and administration costs reasonably allocable to these activities. Proceeds received from the disposition of petroleum and natural gas properties are accounted for as a reduction to the capitalized costs unless this treatment would result in a material change (20%) in the rate of depletion in which case the gain or loss would be reported in earnings.

Capitalized costs are depleted and depreciated using the unit-of-production method, based on total proven petroleum and natural gas reserves, before royalties, as determined by independent evaluators. For purposes of the depletion and depreciation calculation, natural gas reserves are converted to a petroleum equivalent unit of measure on the basis of their approximate relative heating value. The carrying values of undeveloped properties are excluded from the depletion and depreciation calculation.

The Corporation applies a ceiling test to capitalized costs, net of accumulated depletion and depreciation, to ensure these do not exceed the estimated undiscounted value of future net revenues from proven petroleum and natural gas reserves, based on year end prices and costs, adjusted for estimated future general and administrative expenses, abandonment and site restoration costs, financing costs and income taxes. The Corporation periodically reviews the costs associated with undeveloped properties to determine whether the costs will be recoverable. If the results of the review indicate an impairment has occurred the amount of impairment is added to the costs subject to depletion.

Substantially all of the Corporation's petroleum and natural gas activities are conducted jointly with others. The financial statements reflect only the Corporation's proportionate interests in such activities.

(b) Future site restoration costs:

Estimated future site restoration costs are provided for over the life of the proven reserves on a unit of production basis. Costs are estimated each year by management in consultation with the Corporation's engineers based on current regulations, costs, technology and industry standards. Actual site restoration expenditures are charged to the accumulated provision account as incurred.

(c) Depreciation and amortization – other assets:

The Corporation provides for depreciation and amortization on equipment and other assets on a declining balance basis at rates varying between 20% to 100% per year.

(d) Stock options:

No compensation expense is recorded when stock options are granted. Any consideration received on exercise of stock options is included in share capital.

(e) Per share amounts:

The Company follows the treasury stock method to determine the dilutive effect of stock options and other dilutive instruments in the calculation of diluted earnings and cash flow from operations per share. Under the treasury stock method only "in-the-money" dilutive instruments impact the dilutive calculation.

Basic per share amounts are computed by dividing earnings and cash flow from operations by the weighted average number of common shares outstanding for the period. Diluted per share amounts are calculated giving effect to the potential dilution that would occur if stock options or other dilutive instruments were exercised or converted to common shares. The treasury stock method assumes that any proceeds upon the exercise or conversion of dilutive instruments would be used to purchase common shares at the average market price of the common shares during the period.

(f) Management estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ materially from those estimates.

(g) Income taxes:

The Company uses the liability method of the allocation in accounting for income taxes. Under this method future income tax assets and liabilities are determined based on "temporary differences" (differences between the accounting basis and tax basis of the assets and liabilities), and are measured using the currently enacted, or substantially enacted, tax rates and laws expected to apply when those differences reverse. Income tax expense is the sum of the Corporation's provision for current income taxes and the difference between opening and ending balances of the future income tax assets and liabilities.

(h) Comparative figures:

Certain 2000 figures in the accompanying consolidated financial statements have been reclassified to conform to the 2001 presentation.

2. Financial Instruments and Credit Risk:

(a) Financial instruments:

The Corporation's financial instruments consist of cash, accounts receivable, accounts payable, and long-term borrowings. Unless otherwise noted, it is management's opinion that the Corporation is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair value of these financial instruments approximate their carrying values, unless otherwise noted.

(b) Credit risk:

The Corporation is subject to credit risk through trade receivables as a substantial portion of its debtors' ability to pay is dependent upon the energy sector in Western Canada. The Corporation performs ongoing credit evaluations of its customers' and joint venture partners' financial condition and limits the amount of credit extended when deemed necessary.

As at December 31, 2001 the Corporation had amounts owing from joint venture partners of approximately $1,082,417 (2000 – $997,725), 39% (2000 – 85%) of which was due from three oil and gas companies.

3. CAPITAL ASSETS:

December 31, 2001	Cost	Accumulated depletion, depreciation and amortization	Net book value
Petroleum and natural gas interests	$ 12,845,455	$ 2,711,576	$10,133,879
Other assets	51,525	20,151	31,374
	$ 12,896,980	$ 2,731,727	$10,165,253

December 31, 2000	Cost	Accumulated depletion, depreciation and amortization	Net book value
Petroleum and natural gas interests	$ 7,625,004	$ 1,029,138	$ 6,595,866
Other assets	19,871	13,969	5,902
	$ 7,644,875	$ 1,043,107	$ 6,601,768

Included within additions to petroleum and natural gas interests is an allocation of general and administrative expenses amounting to $203,325 (2000 – $nil).

In calculating the ceiling for petroleum and natural gas interests, market prices of $20.03 per barrel for oil, $14.00 per barrel for natural gas liquids and $3.31 per thousand cubic feet for natural gas were used. Based on these December 31, 2001 prices, the Company's costs to be recovered from operations exceeded future net revenue from proven reserves by approximately $670,000 before tax. However, average market prices for oil, natural gas liquids and natural gas were stronger during 2001 than their respective prices at December 31, 2001. During 2001, the Company received $27.80 per barrel for oil, $25.69 per barrel for natural gas liquids and $5.30 per thousand cubic feet for natural gas. Based on these prices, the Company's future net revenues from proven reserves were in excess of related costs to be recovered. Accordingly, the Company did not record a reduction in the carrying value of petroleum and natural gas interests at December 31, 2001.

A provision for site restoration costs totaling $153,464 (2000 – $54,298) is included in depletion, depreciation and amortization expense. The estimated future site restoration costs to be accrued over the remaining proven reserves are approximately $1.1 million.

4. LONG-TERM DEBT:

At December 31, 2001, the Corporation had a revolving demand facility with a Canadian Chartered Bank in the maximum amount of $6,000,000 (2000 – $4,500,000). The facility is repayable on demand and advances bear interest at the bank prime rate plus 1%. The facility is subject to annual review with the next review to be completed in May 2002. The bank has advised the Corporation that, subject to the Corporation maintaining an adequate borrowing base and satisfying conditions as outlined in the credit agreement, advances will remain outstanding with no principal repayments required. Accordingly, the debt is reflected as non-current in the accounts.

The facility is secured by a fixed and floating charge debenture in the amount of $10,000,000 and a general security interest on all of the Corporation's petroleum and natural gas assets.

5. SHARE CAPITAL:

(a) Authorized:

Unlimited common voting shares

Unlimited preferred shares issuable in series

(b) Issued:

	2001		2000	
Common shares	**Number of Shares**	**Amount**	Number of Shares	Amount
Balance, beginning of year	**14,656,328**	**$ 1,671,842**	13,006,328	$ 1,182,742
Options exercised	**175,000**	**58,850**	514,000	91,500
Warrants exercised	**–**	**–**	1,136,000	397,600
	14,831,328	**1,730,692**	14,656,328	1,671,842
Share purchase loan		**(99,227)**		(99,599)
Balance, end of year	**14,831,328**	**$ 1,631,465**	14,656,328	$ 1,572,243

(c) Options:

The Corporation's stock option plan provides for the issue of stock options, which vest after six months, to directors, officers, employees, consultants and other key personnel. The number of stock options outstanding as at December 31, 2001 was 1,209,333 exercisable at prices ranging from $0.15 to $0.45 and expiring on dates from 2003 to 2006. Changes in options outstanding are as follows:

	2001		2000	
	Options	**Weighted average**	Options	Weighted average
Beginning of year	**1,384,333**	**0.28**	1,133,333	0.17
Granted	**210,000**	**0.42**	765,000	0.37
Exercised	**175,000**	**0.34**	514,000	0.18
End of year	**1,419,333**	**0.30**	1,384,333	0.28
Exercisable	**1,209,333**	**0.28**	784,333	0.22

The following table sets out the information relating to stock options outstanding at December 31, 2001:

Range Of Exercise Prices	Number outstanding at Dec. 31, 2001	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable at Dec. 31, 2001	Weighted average exercise price
$ 0.15	403,333	1.4	$ 0.15	403,333	$ 0.15
$ 0.25	196,000	2.7	$ 0.25	196,000	$ 0.25
$ 0.35	90,000	3.1	$ 0.35	90,000	$ 0.35
$ 0.37	520,000	3.7	$ 0.37	520,000	$ 0.37
$ 0.40	130,000	4.7	$ 0.40	–	$ –
$ 0.45	80,000	5.0	$ 0.45	–	$ –
$ 0.15 – $0.45	1,419,333	3.4	$ 0.30	1,209,333	$ 0.28

(d) Share purchase loans:

During 2000 the Corporation authorized the issue share purchase loans totaling $100,000 for two officers. At December 31, 2001, $99,227 of this facility had been drawn in respect of purchase of 220,050 common shares at an average price of $0.49. These loans are without interest and are secured by common shares purchased.

6. INCOME TAXES:

The provision for income taxes differs from the amount obtained by applying the combined Federal and Provincial income tax rate of 42.6% to income before income taxes. The difference relates to the following items:

	2001	2000
Statutory tax rate:	**42.6%**	44.6%
Expected provision	**$ 521,516**	$ 809,842
Non deductible crown payments, net of royalty credits	**572,628**	354,618
Changes in enacted tax rates	**(66,799)**	–
Resource allowance	**(432,273)**	(386,404)
Other	**(134,824)**	5,670
	$ 460,248	$ 783,726

The tax effects of temporary differences that give rise to significant portions of future tax assets and future tax liabilities at December 31, 2001 are presented below:

	2001	2000
Tax liabilities:		
Capital assets	**$ (1,883,934)**	$ (1,573,544)
Tax assets:		
Future site restoration	**76,031**	28,276
Share issue costs	**903**	3,092
	76,934	31,368
Net tax liability	**$ (1,807,000)**	$ (1,542,176)

7. PER SHARE AMOUNTS:

In 2001 the Corporation adopted a new standard for the computation, presentation and disclosure of earnings per share. Under the new standard, the treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments. Under the treasury stock method, only dilutive instruments where the market price exceeds issue price impact the dilutive calculations.

In computing diluted per share amounts, 613,039 (2000 – 297,905) shares were added to the 14,741,924 (2000 – 13,403,753) weighted average number of common shares outstanding during the year for the dilutive effect of stock options. In 2001 no options to purchase common shares were excluded in the computation because the options were out of the money. No adjustments were required to reported earnings and cash flow from operations in computing diluted per share amounts.

Prior period diluted earnings and funds from operations per share have been restated for this change. As a result of this change in accounting policy, diluted earnings per share increased by $0.01 and diluted funds from operations per share was increased by $0.03 in 2001.

8. Related Party Transactions:

At December 31, 2001, accounts receivable includes $127,907 due from a company controlled by certain directors and officers of the Corporation.

During the year the Corporation acquired a 50% interest in certain oil and gas producing properties for $860,161. The remaining 50% of the properties was purchased by the above mentioned company, certain directors and officers.

During the year ended December 31, 2001, the Corporation paid $247,626 for engineering services and well site supervision provided by a company of which a director of the Corporation is an officer and director. At December 31, 2001 accounts payable included $27,486 relating to such services.

The Corporation also paid $598,174 for drilling services provided by a company of which a director of the Corporation is an officer and director. At December 31, 2001 accounts payable included $114,948 relating to such services.

The value of the engineering and drilling services was recorded at an exchange amount equal to their competitively priced market value.

9. Contingencies:

A former consultant to the Company has filed a claim against the Company, alleging breach of trust and misrepresentation. The claim seeks damages of $100,000. The claim process is in the preliminary stages and at this stage it is not possible to determine the likely outcome. Accordingly no provision has been made with respect to this amount.

Corporate Information

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Kenneth M. Gilbreath
Director, Vice-President and C.O.O.

Dwight D. Fieseler, CGA
Controller

Randy Kwasnicia
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Todd McAllister
Director

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Engineers – Oil and Gas Evaluations
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